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**November 14, 2005**

**AGENDA ITEM 6a**

**TO : MEMBERS OF THE INVESTMENT COMMITTEE**

- I. SUBJECT:** International Fund Services Contract Renewal
- II. PROGRAM:** Risk Managed Absolute Return Strategies Program
- III. RECOMMENDATION:** Staff is recommending the Investment Committee approve one of the following:
- 1) *Preferred Recommendation* – Approve: (a) an exemption from competitive bidding based on Best Business Practices for the contract to provide the portfolio management platform for the Risk Managed Absolute Return Strategies Program; and (b) an annual review contract to International Fund Services for these services,  
or
  - 2) *Alternative Recommendation* - Approve an exemption from competitive bidding based on Best Business Practices for International Fund Services for the contract to provide the portfolio management platform for the Risk Managed Absolute Return Strategies Program.

**IV. ANALYSIS:**

Background

At the February 18, 2003 Investment Committee meeting, the Committee approved the selection of International Fund Services (IFS) to serve as the administrator for the Risk Managed Absolute Return Strategies (RMARS) Program (see Attachment 1). The IFS contract was awarded based on the “Best Business Practices” exemption from competitive selection, due to the specialized services IFS provides CalPERS.

The original contract was for a one year term with two one-year extensions, based on the provisions of the Best Business Practices exemption. The current contract expires on May 1, 2006.

#### CalPERS' Experience with IFS

Less than three years ago, staff selected IFS from the four top-rated hedge fund administrators for recommendation to the Investment Committee. IFS was recommended based on the following reasons:

- 1) The ability to provide an accounting platform to provide reconciled performance numbers in accordance with US GAAP.
- 2) The level of commitment to providing the resources needed to build a risk model using position level transparency to generate risk factor exposures for the various types of hedge fund strategies in the RMARS portfolio.
- 3) The progress made in providing a web accessible information system that can serve as a document database of legal and business documents for the RMARS Program.
- 4) The resources committed to building a hedge fund database that can be used by staff to model hedge fund strategies used in portfolio construction research.
- 5) IFS's reputation as one of the most technologically advanced hedge fund administrators.

Over the last 31 months, IFS has exceeded staff's expectations in both the quality and the timeliness of the services and analytical tools provided to CalPERS. The efforts of IFS have resulted in developing a portfolio management platform that incorporates fund accounting, risk reporting, data management, and performance analytics. In addition, IFS continues to research other analytical tools that will reside on the platform and assist staff in managing the RMARS Program.

#### Survey of the Hedge Fund Administration Industry

Prior to making the current recommendations, staff surveyed the market to determine whether other hedge fund administrators offer the same level of services and analytical tools currently used to manage the RMARS Program. To obtain this information, staff sent a survey to the ten most widely used hedge fund administrators. The survey was designed to determine: 1) the types of services offered to clients, 2) the level of technology available to clients for managing data, 3) the type of quantitative tools available to clients for risk analysis and portfolio construction, and 4) the number of hedge funds, fund-of-funds, and the amount of capital each firm administers on behalf of its clients. The ten firms that received the survey are: HSBC, Bank of New York, IFS, Goldman Sachs, Citco, SEI, Citigroup, DPM Mellon, BISYS, and Fortis. Attachment 2 contains the survey.

Of the ten firms sent surveys, eight completed the survey and one firm responded that its capabilities do not meet CalPERS needs. Below are the primary points taken from the responses to the survey.

1. IFS is the only firm that provides all the services and quantitative tools on a single platform needed to manage all aspects of the RMARS Program.
2. Five of the eight hedge fund administrators who responded to the survey do not have the full complement of risk reporting and analytical tools offered by IFS.
3. A large disparity exists between IFS and the other hedge fund administrators in regard to the sophistication of its quantitative analytical tools.
4. IFS is one of the top administrators in terms of providing services to a large number of hedge funds (380+) and fund-of-funds (150+) with total capital in excess of \$110 billion.

#### Criteria for Annual Review Contract & Best Business Practice Exemption

Under Board Resolution 92-04B-4, CalPERS may award contracts without a defined duration if the Board determines an undefined duration is necessary to fulfill the Board's duty to serve the interests of System members and beneficiaries, including the interest in defraying administrative expenses. The Board must consider the impact of an undefined term upon the System's interests in obtaining quality services at a reasonable cost, the System's ability to monitor the performance of contractors with lengthy, or undefined, contract terms, and to take corrective action, including expeditious termination of the contract, if necessary to fulfill the Board's fiduciary duties, and any other factors the Board may deem prudent under the particular circumstances.

An exemption from competitive bidding can be approved by the Board or CEO if either has determined that a new or current contractor can competently and expeditiously provide the specific services; and can do so at a reasonable fee; and that the selection is based on a CalPERS' Best Business Practice decision.

A CalPERS' Best Business Practice can best be defined as an action that meets the Board's fiduciary duties to:

- (a) ensure the prompt delivery of benefits and related services to CalPERS' members and beneficiaries;
- (b) maximize investment returns while minimizing for risk of loss; and
- (c) defray reasonable expenses of administering the system.

#### Staff Recommends the Board Approve an Exemption from Competitive Bidding Based on Best Business Practices and the Award of an Annual Review Contract

As stated above, a number of requirements must be met in order for the Board to approve an exemption from competitive bidding. Staff believes the actions described below are evidence each requirement has been met.

*Competence* – In addition to CalPERS experience with IFS over the last 31 months, the industry periodical, *Global Custodian*, has assigned IFS with the “Best in Class” rating over the last several years. The rating is based on the annual survey conducted by *Global Custodian* where clients rate their hedge fund administrator in eight specific service areas.

*Timeliness* - The services, many of which are customized for CalPERS, have been provided to CalPERS within the specified timeframes.

*Cost Effectiveness* - IFS spent a significant amount of resources building one of the most comprehensive hedge fund platforms available today. The costs of these services charged to CalPERS are below market prices. Currently, CalPERS pays IFS per fund. This equates to approximately 6 basis points of the assets in the RMARS Program. Based on the new fee proposal from IFS, the costs of administering the RMARS Program will be reduced to 5 basis points even though the number of funds will increase.

*Benefits and Services to CalPERS’ Members* – The IFS platform allows CalPERS to leverage its resources in managing a program with unique needs. The cost of outsourcing these services to a variety of different providers would be more expensive and more difficult to manage because the tools would not be on an integrated platform.

*Minimize Risk and Maximize Returns* - The platform allows staff to better manage the risks associated with investing in each hedge fund and the overall portfolio. Managing the risk is critical to maximizing the expected returns. In addition, a change in the provider will cause a disruption in the risk reporting because the information that resides on the IFS platform can not simply be transferred to another provider.

It is important for the Board to know that:

1. CalPERS has a Termination at Option in the contract that allows CalPERS to terminate the agreement with 30 days notice, for any reason.
2. Staff will regularly monitor the market to determine the progress made by the other hedge fund administrators to ensure CalPERS is using the best provider and paying less than the market rate.

Alternatively, Staff Recommends the Board Approve an Exemption from Competitive Bidding Based on the Best Business Practices Exemption

If the Investment Committee does not approve the use of an annual review contract for IFS, which is the Preferred Recommendation, staff requests the Board approve an award of the contract to IFS under the Best Business Practices exemption. As previously cited, staff believes the requirements for an exemption from competitive bidding have been met.

**V. STRATEGIC PLAN:**

Goal VIII: Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first to pay benefits and, second, to minimize, and stabilize employer contributions.

**VI. RESULTS/COSTS:**

Contracting with IFS will maintain the continuity of having an integrated platform (fund accounting, risk reporting, data management, and performance analytics) for the RMARS Program. The IFS platform plays a very important role in assisting staff to enhance returns and monitor as well as reduce many of the risks associated with investing in hedge funds.

The current annual cost of the IFS contract is approximately \$850,000, which is less than 6 basis points a year on a \$1.5 billion portfolio. Going forward, the cost of the IFS contract is expected to increase modestly due to an increase in the number of hedge funds in the RMARS Program and additional tools to the platform. Staff estimates the cost to administer the RMARS Program over the next 2 years will be 5 basis points on average per year.

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